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Margaret White Nally

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SELECTED PROVISIONS OF THE TECHNICAL AMENDMENTS ACT OF 1958 AND SMALL BUSINESS TAX REVISION ACT OF 1958

By MARGARET WHITE NALLY, C.P.A., New York Chapter ASWA

Introduction

Accountants, lawyers and businessmen generally have been watching and waiting as the Mills Bill slowly wound its way through the House and on into the Senate to emerge as Title I, Technical Amendments Act of 1958. The Mills Bill started as a bill to correct unintended benefits and hardships and to make technical amendments, but as is usually the case, many pressure groups clamored for other legislative changes in the 1954 Code and, as a consequence, like Topsy, it just "growed." Title II, Small Business Tax Revision Act of 1958 was introduced as a separate bill but for expediency was combined with the Technical Amendments Act into a single act. The "Acts" were signed into public law by President Eisenhower on September 2, 1958.

Thus we have seen what began as a modest tax bill emerge from the Congressional grist-mill as a monumental work containing many substantive changes in tax base, allowable deductions and timing of payments. Individual, corporate, estate and gift tax returns are affected. Some of the new provisions are effective on the date of enactment (September 2, 1958), many are effective on dates comparable to the 1954 Code, and many have special effective dates. The Act will have to be studied carefully if the full benefits of the new provisions are to be availed of and timely action taken.

The new law contains 109 sections, eleven of which provide only for grammatical, typographical and technical errors. Of the remaining sections, I have selected several which I feel will be of particular interest and which will have a marked impact on business decisions.

Selected provisions

Sec. 29 Adjustments Required by Changes in Method of Accounting

Section 481 of the 1954 Code attempted to settle the controversy which had arisen under the 1939 Code between taxpayers and the Treasury Department when a taxpayer made a change in the method of computing taxable income. Unfortunately, Sec. 481 only added to the dilemma since the Commissioner contended that it contained benefits which were not intended and therefore refused to approve changes in accounting methods pending further clarification of the law. It is hoped that Section 29 of the 1958 law will settle the problem. In order to fully understand what this new provision is attempting to accomplish, let me review briefly for you the events leading up to its enactment.

Under the 1939 Code, if no method of accounting was regularly employed in keeping taxpayers books or if the method employed did not clearly reflect income, the Commissioner could prescribe such method as in his opinion did clearly reflect income. If the Commissioner insisted on the change, it was referred to as an "involuntary change." If the taxpayer wanted to initiate a change (that is, make a voluntary change), it was necessary under the Regulations to secure the consent of the Commissioner. The distinction between a voluntary change and an involuntary change created a deplorable situation. In an involuntary change, for example where a taxpayer was forced to change from a cash to accrual basis, the courts usually held for the taxpayer by refusing the Commissioner the right to tax accounts receivable and/or eliminate opening inventories. Thus it was possible for income to escape taxation. However, where a taxpaper voluntarily changed methods he was subjected to transition adjustments as a condition to obtaining the consent of the Commissioner. Where the adjustments would result in a very large income in the year of the change, therefore, it was to the taxpayers interest to perpetuate the erroneous method until the Commissioner forced a change.

The 1954 Code attempted to settle this conflict by adding Section 481 (Adjustments Required By Changes in Method of Accounting) and formalizing in the Code (under Section 446(e)) the requirement

that a taxpayer who changes his method of accounting secure the consent of the Secretary or his delegate. Section 481 requires that in making a change there shall be taken into account these adjustments necessary to prevent duplications or omissions *except* there shall not be taken into account any adjustment attributable to a taxable year to which the 1954 Code did not apply, that is, generally, years beginning before January 1, 1954. This general rule was subject to certain limitations where the adjustments were substantial.

The opportunity to avoid tax on certain pre-1954 items undoubtedly prompted many taxpayers to seek a change in accounting method and consequently the Commissioner was flooded with requests for permission to make such change. The Treasury Department was not satisfied with this section of the Code and therefore refused to act on these requests pending further clarification of the law. The Commissioner contended that a literal interpretation of Section 481 could conceivably result in the loss of substantial revenue to the Treasury.

Section 29 in the 1958 law is Congress' answer to the problem. Under this section, changes initiated by the taxpayer, either by requesting permission from the Commissioner or by shifting from one method to another without permission, are subject to adjustments as to pre-1954 items. If the Commissioner forces a change, adjustments of pre-1954 items are not authorized. So once again we return to the situation where the taxpayer who makes a voluntary change from an incorrect to a correct method is penalized whereas the taxpayer who continues to use an erroneous method until forced to change benefits. Of course the statute of limitations has run out on calendar year 1954, and each year thereafter the benefits which could result from this provision decrease as an increasing proportion of the adjustments become attributable to years covered by the 1954 Code. So presumably we can expect the Commissioner not to compel a change in years where substantial pre-1954 items would escape tax.

In view of the foregoing, taxpayers who elected to make a change under the 1954 Code prior to September 2, 1958, should reexamine their position, since it may be advisable to make an election under the new act to go back to the old method. The election must be made within six months after the date of enactment of the Act and is not available if the taxpayer has already received permission to change or was compelled to change prior to the enactment of the act.

The new law also adds a special rule for pre-1954 adjustments where taxpayer initiates a change. Under the 1954 Code, the adjustments attributable to a change in method were to be taken into account in the year of change, or if the increase in taxable income from applying the adjustments was more than $3,000, then the adjustment could be spread over the year of the change and the two preceding years or over as many of the consecutive years preceding the year of change as could be established correctly by the taxpayer with the use of the new accounting method. The new act adds another spreading device for adjustments attributable to pre-1954 Code years. One-tenth of the net amount of the adjustment can be taken into account in each of the ten taxable years beginning with the year of the change. This is subject to a qualification that where the year of change was a taxable year beginning after December 31, 1953 and ending after August 16, 1954, but before January 1, 1958, the taxpayer may elect to spread adjustments for ten years commencing with the first taxable year beginning after December 31, 1957. However, if the taxpayer does so elect, the ten years to which adjustments can be spread will be reduced by the same number of years which are barred by the statute of limitations beginning with the actual year of change and the date of enactment of the new law.

Other limitations and special rules pertaining to adjustments required by changes in method of accounting are included in the amendment. However, the important points to remember in connection with the new amendment are that pre-1954 adjustments are not taken into account if the Commissioner compels the change and the rules for spreading adjustments attributable to pre-1954 items where the taxpayer initiates the change have been expanded to provide a ten-year spread.

Section 15 Improvements On Leased Property

This amendment adds section 178 to the 1954 Code and is effective to any costs of acquiring a lease after July 28, 1958 or the cost of improvements commenced thereafter, unless before July 29, 1958, the lessee was under a legal obligation to make the improvements commenced after that date.

Under the 1954 Code, improvements made

by a lessee on leased real property should be depreciated if the length of the existing lease is longer than the life of the improvements, or should be amortized if the length of the lease is less than the life of the improvements. Under existing Treasury practice and certain case law, the renewal of leases were not taken into account in determining the period over which a lessee's improvement was to be written off, *unless* the facts showed with reasonable certainty that the lease would be renewed. The establishment of *"reasonable certainty"* that the lease would be renewed made it unlikely that the renewal periods would be taken into account in most cases. Thus it was possible for a lessee, who had decided in his own mind to exercise his option to renew a lease, to make improvements during the advanced stages of the lease and to write them off over the shorter period, with the Treasury Department in most instances unable to prove that a "reasonable certainty" of renewal existed. It was this difficulty of determining whether or not a lease would be renewed that prompted this new Code section detailing the rules to be applied to writing off the cost of improvements on leased property.

Generally, the term of a lease shall be considered to include any renewal or continuation options unless the lessee can show with more probability than not that the lease will not be renewed, subject, however, to the following qualifications:

(1) The new provision does not apply if the unexpired lease period (determined without regard to any unexercised option to renew) accounts for 60 percent or more of the useful life of the improvement;

and (2) The new provision does not apply to the cost of purchased leasehold, if 75 percent or more of such cost is attributable to the unexpired lease term.

A further provision of this section deals with related lessee and lessor and the general rule is that the cost of the improvement made by the lessee on the leased property may be recovered only over the remaining useful life of improvements.

Finally, where the 60 percent or 75 percent rules discussed previously do not apply, depreciation or amortization shall be based on the remaining term of the lease plus the renewal period in any case where the lessee has notified the lessor of an intention to renew. Also, the same rule as to the aggregate terms of the lease will apply where the facts indicate there is a "reasonable centainty" that the lease will be renewed or extended.

Section 11 Charitable Contribution Carry-over for Corporations

1954 Code Section 170(b), relating to the two-year carry-over for charitable contributions made by corporations in excess of 5 per cent of their taxable income, has been amended in respect to corporations having net operating loss carry-overs. No charitable contribution carry-over is allowable for contributions which reduce taxable income in a year and which in turn increases a net operating loss carry-over to a succeeding year. This amendment may best be illustrated by the following example:

In 1957, a corporation has a net operating loss of $100,000 which is net operating loss carry-over to 1958. In 1958, the corporation has taxable income of $100,000 before deducting charitable contributions of $5,000. In determining the amount of 1957 loss absorbed in 1958, the charitable contributions made in 1958 are taken into account, so that $5,000 of the 1957 loss is available as a carry-over to 1959. As the taxpayer received a tax benefit in the form of an increased net operating loss deduction applicable to 1959, from the charitable contributions, he is denied a contributions carry-over of $5,000, even though the contributions in 1958 exceeded 5 per cent of his taxable income.

This amendment applies to 1954 Code years, that is taxable years beginning after 1953 and ending after August 16, 1954.

Section 5 Improper Payments to Foreign Officials

This section amends 1954 Code Section 162 and applies to expenses paid or incurred after September 2, 1958.

Under existing law, an expense which is paid or incurred in carrying on a trade or business is deductible provided it is ordinary and necessary. It is not deductible if it is clear that the expense is a device to avoid the consequences of violations of a law or otherwise contravenes the Federal policy expressed in a statute or regulation. The problem arises, however, where taxpayers doing business in foreign countries are required to pay bribes or give kickbacks to foreign government officials where the foreign government itself demands or

acquiesces in payment. The question raised is whether these expenses are "ordinary and necessary." Since legal recourse is not available to the taxpayer, the Internal Revenue Service found it difficult to sustain the position that such expenses were not ordinary and necessary to the taxpayer's business. This put the Service in the awkward position of recognizing the existence of a practice which it did not wish to condone and which Americans found repugnant.

The new amendment, therefore, denies deduction of any payments, made directly or indirectly, to officials of foreign countries which would be considered unlawful under U. S. laws, if such were applicable, even though the foreign government itself demanded or acquiesces in the payment.

Section 97 Deductibility of Accrued Vacation Pay

The Treasury's position on the accrual of vacation pay has changed over the years. Some years back, the Treasury ruled that vacation pay could be accrued if the liability could be estimated with a reasonable degree of accuracy. Accordingly, if it was the established policy of an employer to grant to his employees paid vacations in a succeeding year for work performed in the current year, the taxpayer would be entitled to accrue for such vacations. The employer was allowed a deduction for such vacations even though some employees terminated prior to the vacation period would not receive any vacation pay.

Following several court decisions in which the accrual of vacation pay was not allowed to the taxpayers because the amount of the liability could not be accurately determined at the year end, the Treasury ruled that vacation pay to be accruable had to be definite in amount, and the liability to each employee firmly established. In other words, the employee had to have an unforfeitable right to his vacation pay at the end of the taxpayer's taxable year. Under this strict requirement, if an employee was terminated, either voluntarily or involuntarily, he would be entitled to the vacation pay he had earned to the date his employment was terminated.

In order not to penalize taxpayers who have continuously accrued vacation pay under the Treasury's former position of reasonable determination of the liability, the Treasury had delayed imposing the stricter requirements. The delay was merely to grant taxpayers time to amend their vacation policies to embrace the stricter requirements, and was not an opportunity for taxpayers who had not previously accrued vacation to suddenly do so, unless their vacation policies contained the unforfeitable right provisions to the vacation payments. The Treasury has several times extended the time for the imposition of the stricter requirements. As most recently extended, the rule generally for years ending after December 31, 1958 would deny accrual unless the fact and the amount of liability to each employee could be determined.

The new amendment further extends imposition of the stricter requirements for determining the accrual of vacation pay by postponing the application of the stricter requirements for taxable years ending before January 1, 1961.

Section 18 Deductions by Corporations for Dividends Received

This amendment was made to close a tax loophole resulting from corporations buying stock just before a dividend was paid and selling it immediately after receiving the dividend. Usually, a stock price will drop when a dividend is paid by the amount of the dividend. Therefore, a corporation engaging in this type of transaction received income against which it could apply the 85 per cent dividend received credit and a short-term loss which could be deducted in full against ordinary income in the case of dealers in security or against capital gains in the case of non-dealers in securities.

The amendment discourages this practice by denying an intercorporate dividend deduction where the stock is not held for a period of 16 days or more. Similarly, the intercorporate dividend deduction is denied where the recipient corporation is simultaneously in both a long and short position on the same stock, and is required to pay over on the stock held short an amount equal to the dividend. A special rule applies where the stock involved has cumulative preferred dividends in arrears for a period of more than 366 days. In this case, the stock must be held for 91 days or more to allow the intercorporate dividend deduction.

This provision is effective for taxable year ending after December 31, 1957 for shares of stock acquired after that date, including transactions closed by short sales made after that date.

Section 64 Election of Certain Small Business Corporations as to Taxable Status

This amendment adds a new subchapter to the 1954 Code (subchapter S, secs. 1371-1377) and is effective with respect to taxable years beginning after December 31, 1957.

When Congress was working out the details of the 1954 Code, the Senate passed, but the Congress did not enact, a provision which would allow certain corporations to be taxed as partnerships. A provision allowing certain proprietorships and partnerships to be taxed as corporations, however, was enacted. It has generally been felt since, that with respect to small businesses, there should be a provision to complement the election available to partnerships, because it allows businesses to select the form of organization best suited to it without worrying about the major differences in tax consequences. Therefore, the provision to allow shareholders in small business corporations the election to be taxed directly on the corporation's earnings, and to forego the payment of the corporate tax, has been revived in the new law.

To qualify as a small business a corporation must:

1) Be a domestic corporation
2) Not be a member of an affiliated group as defined in section 1504
3) Have no more than ten shareholders
4) Have as shareholders only individuals or estates
5) Not have as shareholders any nonresident aliens
6) Have only one class of stock

All shareholders must consent to the election which must be made either in the first month before the beginning of the taxable year for which the election is being made or in the first month of that year.

If the election is exercised, the shareholders include in their own income for tax purposes, the current taxable income of the corporation *whether or not distributed.* Since the income has not been taxed at the corporate level, there is no dividend received credit or exclusion. The income is generally treated as ordinary income to the shareholder except in the case of long-term capital gains which carry over to the shareholder level.

Other rules for treating net operating losses and for adjustments to the basis of shareholder's stock in the case of losses, etc. are also treated in this provision. In addition, on September 25, 1958, temporary regulations were issued as a guide to taxpayers who might elect this special tax treatment.

The election under this subchapter may be terminated in any one of the following ways:

1) If there is a new shareholder and he does not consent to the election.
2) If all the shareholders consent to its revocation.
3) If the corporation ceases to qualify as a small business corporation.
4) If the corporation derives more than 80 per cent of its gross receipts from sources outside the U.S.
5) If more than 20 per cent of the corporation's gross receipts are derived from interest, dividends, rents, royalties, or other forms of passive income.

If a corporation has made an election under this provision and such election has been terminated or revoked, the corporation (or any successor) is not eligible without the Treasury's consent to elect this tax treatment until its fifth year after the beginning of the year in which the termination or revocation is effective. This limitation was designed to keep a corporation from electing in and out of these provisions.

Section 204 Additional First Year Depreciation Allowances for Small Business

Although this section is entitled Additional First Year Depreciation Allowance for Small Business, it is applicable to any business, irrespective of size, except trusts, and provides for an election to write off 20 per cent of the cost of tangible personal property in the year of acquisition, in addition to regular depreciation on the balance. The additional 20 per cent allowance applies to any tangible personal property costing in the aggregate not more than $10,000, or $20,000 in the case of a taxpayer filing a joint return, purchased during a year, for use in a trade or business or for holding for production of income, which is of a character subject to the allowance for depreciation and with a useful life of 6 years or more at the time of acquisition. However, the allowance is not applicable to property:

1. Acquired from a related person, as defined in the Code,
2. Acquired by one member of an affiliated group from another member of the same affiliated group,
3. The basis of which is determined by reference to the adjusted basis

of such property in the hands of the person from whom acquired,

4. Acquired from a decedent.

In the case of an affiliated group, all members of such group shall be treated as one taxpayer in applying the $10,000 limitation. Ownership of more than 50 per cent of the stock of a company constitutes control for the purpose of determining affiliation in applying this limitation.

This amendment applies to taxable years ending after June 30, 1958 for tangible personal property purchased after December 31, 1957.

Section 205 Increase of Minimum Accumulated Earnings Credit

As an aid to small businesses, who often have difficulty in justifying the need for the retention of earnings because of the absence of specific plans for the use of such earnings in the business, the minimum accumulated earnings credit has been increased from $60,000 to $100,000. Accordingly, companies can now retain earnings up to $100,000 without having to worry or be concerned about the imposition of the penalty tax on improper accumulation of earnings. The increase in the accumulative earnings credit increases the advantages to be gained from separate corporations for the various activities of a business. Naturally, a business can retain any amount of accumulated earnings in excess of $100,000 without incurring the penalty tax, if it can prove the need for such earnings in the business. The amendment increasing the accumulated earnings credit to $100,000 is effective for taxable years beginning after December 31, 1957.

* * *

Section 203 Three Year Net Operating Loss Carryback

This section, which is applicable to all businesses, whether small or large, provides for the carry-back of a net operating loss deduction to three years instead of two years. There have been no changes made to the 5 year carry-over of a net operating loss deduction. The three year carry-back is applicable to a net operating loss for any taxable year ending after December 31, 1957. The amendment provides with respect to a net operating loss for a fiscal year ending in 1958, that the amount of the carry-back to the third preceding year shall be a pro rata part of the net operating loss for the fiscal year, based on the number of days in the 1958 portion of the year.

In summation, your attention is directed to several important points:

1. With respect to changes in accounting methods, *any* change of accounting method adopted by the taxpayer without the consent of the Commissioner after the effective date of the 1954 Code, and prior to the date of enactment of the new amendment, should be re-examined to determine whether or not to elect, within the six month's limitation, to go back to the old method.
2. With respect to improvements on leased property, care should be exercised in negotiating new leases in the light of the new law. Use of renewal options that qualify under the 60 and 75 per cent rules can result in greater amortization and/or depreciation deductions. Renegotiations of existing leases on which substantial work on improvements remains to be done should be considered.
3. With respect to improper payments to foreign officials, U. S. companies faced with the necessity of continuing such payments should give immediate attention to the problem since expenses incurred after September 2 are denied for U.S. tax purposes. In this connection, consideration may be given to the establishment of a foreign subsidiary or possibly the use of an independent contractor (rather than an employee) relationship with the person through whom payment is effected. The latter device, however, may not always be successful.
4. With respect to the election of certain small business corporations to be taxed as partnerships, eligible closely-held corporations had a rare opportunity to exercise hindsight by making an election prior to December 1, 1958 to be exempt from corporate income tax for taxable years beginning in 1958 prior to September 3. In subsequent years the election must be made not later than the end of the first month of the taxable year. However, companies which were not eligible during their current taxable year

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RETIREMENT TEST. Three changes were made in the retirement test provision. When a person reaches retirement age (65 for men and 62 for women) he or she may not earn over $1200 gross wages or salary or realize over $1200 net profit while rendering substantial services in his business and receive all social security checks until he or she reaches 72.

Provision	Effective date
1. No benefit loss for month (a) an employee's gross wages or salary do not exceed $100 (b) a self-employed person does not render substantial services in his business	taxable years beginning after 8/58
2. Charge excess earnings beginning with first month of year (as previously excess earnings above $1200 will be charged to the months of the year in units of $80 or any part therof.) Under old law charging excess earnings beginning with the last month of taxable year and working backward operated to the disadvantage of some beneficiaries.	taxable years beginning after 8/58
3. Filing of an annual report of earnings is eliminated as a requirement for a beneficiary who receives no benefits for the year because of the retirement test (excess earnings)	taxable years beginning after 8/58

MISCELLANEOUS:

Provision	Effective date
1. Clarify definition of fraud (section 208 of Social Security Act)	enactment date
2. Provide for charging for certain services (including forwarding of mail not connected with program)	enactment date
3. Remove requirement that an attorney must file "right to practice" certificate	enactment date
4. Provide that payments received by a State or local government employee while he is on sick leave be counted as wages after he reaches retirement age.	enactment date

Contact your nearest Social Security District Office for more information, when needed, about social security benefits.

Contact your nearest Internal Revenue Service for more information, when needed, about social security taxes.

Source: Enactment of the Social Security Amendments of 1958 and Minor Social Security Bills, Bureau of Old-Age and Survivors Insurance, Social Security Administration, Department of Health, Education and Welfare.

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may still have an opportunity to rearrange family shareholdings in closely-held corporations so as to be eligible with respect to the succeeding taxable year. In the case of calendar year corporations that wish to elect for 1959, the necessary changes in shareholders and capitalization must be made not later than January 31, 1959.

5. With respect to the additional first year depreciation allowances, two clarifying points should probably be brought out: (1) a "reasonable allowance" for depreciation is still deductible after the 20% is deducted, and (2) the 20% allowance is determined on "cost." There is no provision for a salvage adjustment.

6. With respect to the increase of the minimum accumulated earnings credit, while this change increases the advantages to be gained from separate corporations for the various activities of a business, beware of Code section 269 which deals with denying benefits in the case of acquisitions to evade or avoid income tax and Code section 1551 which deals with the disallowance of surtax exemption and accumulated earnings credit.

In conclusion I would like to reiterate that the new act makes many changes, some very important, some very minor. The effective dates of the various provisions vary and it behooves all of us to study these provisions and to take timely action where a provision affects either the company we work for or our clients.